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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-123600-16]

RIN 1545-BN55

Guidance under Section 851 Relating to Investments in Stock and Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document provides guidance relating to the income test and the asset diversification requirements that are used to determine whether a corporation may qualify as a regulated investment company (RIC) for federal income tax purposes. These proposed regulations provide guidance to corporations that intend to qualify as RICs.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-123600-16), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 4 pm to: CC:PA:LPD:PR (REG-123600-16), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-123600-16).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Matthew Howard of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 317-7053; concerning submissions of comments and requests for a public hearing, Regina Johnson (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to RICs. Section 851 of the Internal Revenue Code (Code) sets forth requirements for qualifying as a RIC.

Section 851(a) provides that a RIC is any domestic corporation that (1) at all times during the taxable year is registered under the Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. 80a-1 – 80a-64 (2016)) (the 1940 Act), as a management company or unit investment trust or has in effect an election under the 1940 Act to be treated as a business development company; or (2) is a common trust fund or other similar fund excluded by section 3(c)(3) of the 1940 Act from the definition of “investment company” and is not included in the definition of “common trust fund” by section 584(a).

To be treated as a RIC for a taxable year, a corporation must satisfy the income test set forth in section 851(b). The income test under section 851(b)(2) requires that at least 90 percent of the corporation's gross income for the taxable year be derived from:

(A) dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the [1940 Act]) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies, and

(B) net income derived from an interest in a qualified publicly traded partnership (as defined in [section 851(h)]).

Section 851(b)(3) provides that to be treated as a RIC a corporation also must satisfy the following asset diversification requirements at the close of each quarter of the corporation's taxable year:

- (A) at least 50 percent of the value of its total assets is represented by—
 - (i) cash and cash items (including receivables), Government securities and securities of other [RICs], and
 - (ii) other securities for purposes of this calculation limited, except and to the extent provided in [section 851(e)], in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and
- (B) not more than 25 percent of the value of its total assets is invested in—
 - (i) the securities (other than Government securities or the securities of other [RICs]) of any one issuer,
 - (ii) the securities (other than the securities of other [RICs]) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses, or
 - (iii) the securities of one or more qualified publicly traded partnerships (as defined in [section 851(h)]).

These proposed regulations relate to the RIC income test and asset diversification requirements. Section A. of this preamble concerns the meaning of security. Section B. of this preamble addresses inclusions under sections 951(a)(1)(A)(i) and 1293(a). These proposed regulations also revise §1.851-2(b)(1) of the existing final regulations to merely incorporate changes to section 851(b)(2) since the existing final regulations were published in the **Federal Register** on November 26, 1960, in TD 6500 (25 FR 11910).

A. Defining Securities

The income test and asset diversification requirements both use the term “securities.” For purposes of the income test, a security is defined by reference to section 2(a)(36) of the 1940 Act, while section 851(c) provides rules and definitions that apply for purposes of the asset diversification requirements of section 851(b)(3) but does not specifically define “security.” Section 851(c)(6), however, provides that the terms used in section 851(b)(3) and (c) have the same meaning as when used in the 1940 Act. An asset is therefore a security for purposes of the income test and the asset diversification requirements if it is a security under the 1940 Act.

The Treasury Department and the IRS have in the past addressed whether certain instruments or positions are securities for purposes of section 851. In particular, Rev. Rul. 2006-1 (2006-1 CB 261) concludes that a derivative contract with respect to a commodity index is not a security for purposes of section 851(b)(2). The ruling also holds that income from such a contract is not qualifying other income for purposes of section 851(b)(2) because that income is not derived with respect to the RIC’s business of investing in stocks, securities, or currencies. Rev. Rul. 2006-1 was modified and clarified by Rev. Rul. 2006-31 (2006-1 CB 1133), which states that Rev. Rul. 2006-1 was not intended to preclude a conclusion that income from certain instruments (such as certain structured notes) that create commodity exposure for the holder is qualifying income under section 851(b)(2).

After the issuance of Rev. Rul. 2006-31, the IRS received a number of private letter ruling requests concerning whether certain instruments that provide RICs with commodity exposure were securities for purposes of the income test and the asset diversification requirements. By 2010, the IRS was devoting substantial resources to

these private letter ruling requests. Moreover, it is not clear whether Congress intended to allow RICs to invest in securities that provided commodity exposure. Consequently, in July 2011, the IRS notified taxpayers that the IRS would not issue further private letter rulings addressing specific proposed RIC commodity-related investments while the IRS reviewed the issues and considered guidance of broader applicability.

Finally, determining whether certain investments that provide RICs with commodity exposure are securities for purposes of the income test and the asset diversification requirements requires the IRS implicitly to determine what is a security within the meaning of section 2(a)(36) of the 1940 Act. Section 38 of the 1940 Act, however, grants exclusive rulemaking authority under the 1940 Act to the Securities and Exchange Commission (SEC), including “defining accounting, technical, and trade terms” used in the 1940 Act. Any future guidance regarding whether particular financial instruments, including investments that provide RICs with commodity exposure, are securities for purposes of the 1940 Act is therefore within the jurisdiction of the SEC.

Section 2.01 of Rev. Proc. 2016-3 (2016-1 IRB 126) provides that the IRS may decline to issue a letter ruling or a determination letter when appropriate in the interest of sound tax administration (including due to resource constraints) or on other grounds whenever warranted by the facts or circumstances of a particular case. If the IRS determines that it is not in the interest of sound tax administration to issue a letter ruling or determination letter due to resource constraints, the IRS will adopt a consistent approach with respect to taxpayers that request a ruling on the same issue. The IRS will also consider adding the issue to the no rule list at the first opportunity.

The Treasury Department and the IRS have reviewed the issues, considered the concerns expressed, considered resource constraints, and determined that the IRS should no longer issue letter rulings on questions relating to the treatment of a corporation as a RIC that require a determination of whether a financial instrument or position is a security under the 1940 Act. Contemporaneously with the publication of these proposed regulations, the Treasury Department and the IRS are issuing Rev. Proc. 2016-50 (2016-43 IRB ____), which provides that the IRS ordinarily will not issue rulings or determination letters on any issue relating to the treatment of a corporation as a RIC that requires a determination of whether a financial instrument or position is a security under the 1940 Act. Thus, for example, the IRS ordinarily will not issue a ruling on whether income is of a type described in the income test of section 851(b)(2) if that ruling depends on whether an instrument is a security under the 1940 Act.

The Treasury Department and the IRS request comments as to whether Rev. Rul. 2006-1, Rev. Rul. 2006-31, and other previously issued guidance that involves determinations of whether a financial instrument or position held by a RIC is a security under the 1940 Act should be withdrawn effective as of the date of publication in the **Federal Register** of a Treasury decision adopting these proposed regulations as final regulations.

B. Inclusions Under Section 951(a)(1)(A)(i) or 1293(a)

In certain circumstances, a U.S. person may be required under section 951(a)(1)(A)(i) or 1293(a) to include in taxable income certain earnings of a foreign corporation in which the U.S. person holds an interest, without regard to whether the foreign corporation makes a corresponding distribution of cash or property to the U.S.

person. Section 851(b) was amended by the Tax Reduction Act of 1975, Pub. L. No. 94-12, section 602, 89 Stat. 26, 58 (the “1975 Act”) (for inclusions under section 951(a)(1)(A)(i)), and by the Tax Reform Act of 1986, Pub. L. No. 99-514, section 1235, 100 Stat. 2085, 2575 (the “1986 Act”) (for inclusions under section 1293(a)), to specify how a RIC treats amounts included in income under section 951(a)(1)(A)(i) or 1293(a) for purposes of the income test of section 851(b)(2). The language added in those amendments provides:

For purposes of [section 851(b)(2)], there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i) or 1293(a) for the taxable year to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included.

The significance of treating an inclusion as a dividend under section 851 is that a dividend is qualifying income under section 851(b)(2). The amendments to section 851(b) made by the 1975 Act and the 1986 Act unambiguously condition dividend treatment of an inclusion under section 951(a)(1)(A)(i) or 1293(a) on a distribution from the foreign corporation’s earnings and profits attributable to the amount included. Absent a distribution, there is no support in the Code for treating an inclusion under section 951(a)(1)(A)(i) or 1293(a) as a dividend under section 851.

Notwithstanding the distribution required by section 851(b), in certain circumstances the IRS has previously issued letter rulings under section 851(b)(2) that permit an inclusion under section 951(a)(1)(A)(i) or 1293(a) to qualify as “other income” derived with respect to a RIC’s business of investing in currencies or 1940 Act stock or securities even in the absence of a distribution. Reading section 851(b)(2) in this manner ignores the requirement in section 851(b) that amounts be distributed in order

to treat these inclusions as dividends. This distribution requirement is a more specific provision than the other income clause. In addition, it cannot be suggested that the distribution requirement was superseded by the other income clause because the other income clause and the distribution requirement for inclusions under section 1293(a) were both added by the 1986 Act. Therefore, these proposed regulations specify that an inclusion under section 951(a)(1)(A)(i) or 1293(a) is treated as a dividend for purposes of section 851(b)(2) only to the extent that the distribution requirement in section 851(b) is met. These proposed regulations further provide that, for purposes of section 851(b)(2), an inclusion under section 951(a)(1) or 1293(a) does not qualify as other income derived with respect to a RIC's business of investing in stock, securities, or currencies.

Proposed Effective/Applicability Date

The rule in §1.851-2(b)(2)(iii) of the proposed regulations applies to taxable years that begin on or after the date that is 90 days after the date of publication in the **Federal Register** of a Treasury decision adopting these proposed regulations as final regulations.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not

apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. The Treasury Department and the IRS specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be made available for public inspection at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Matthew Howard, Office of Associate Chief Council (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

Statement of Availability of IRS Documents

The IRS revenue rulings and revenue procedure cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at www.irs.gov.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.851-2 is amended by:

1. Revising paragraphs (b)(1) and (b)(2)(i).
2. Adding paragraph (b)(2)(iii).

The addition and revisions read as follows:

§ 1.851-2 Limitations.

* * * * *

(b) Gross income requirement--(1) General rule. A corporation will not be a regulated investment company for a taxable year unless 90 percent of its gross income for that year is income described in paragraph (b)(1)(i) of this section or in paragraph (b)(1)(ii) of this section. Any loss from the sale or other disposition of stock or securities is not taken into account in the gross income computation.

(i) Gross income amounts. Income is described in this paragraph (b)(1)(i) if it is gross income derived from:

- (A) Dividends;
- (B) Interest;

(C) Payments with respect to securities loans (as defined in section 512(a)(5));

(D) Gains from the sale or other disposition of stocks or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended);

(E) Gains from the sale or other disposition of foreign currencies; or

(F) Other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to a regulated investment company's business of investing in such stock, securities, or currencies.

(ii) Income from a publicly traded partnership. Income is described in this paragraph (b)(1)(ii) if it is net income derived from an interest in a qualified publicly traded partnership (as defined in section 851(h)).

(2) Special rules--(i) For purposes of section 851(b)(2)(A) and paragraph (b)(1)(i)(A) of this section, amounts included in gross income for the taxable year under section 951(a)(1)(A)(i) or 1293(a) are treated as dividends only to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year that are attributable to the amounts included in gross income for the taxable year under section 951(a)(1)(A)(i) or 1293(a). For allocation of distributions to earnings and profits of foreign corporations, see § 1.959-3.

* * * * *

(iii) For purposes of section 851(b)(2)(A) and paragraph (b)(1)(i)(F) of this section, amounts included in gross income under section 951(a)(1) or 1293(a) are not treated as other income derived with respect to a corporation's business of investing in stock, securities, or currencies. The rule in this paragraph (b)(2)(iii) applies to taxable

years that begin on or after the date that is 90 days after the date of publication in the **Federal Register** of a Treasury decision adopting these proposed regulations as final regulations.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

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